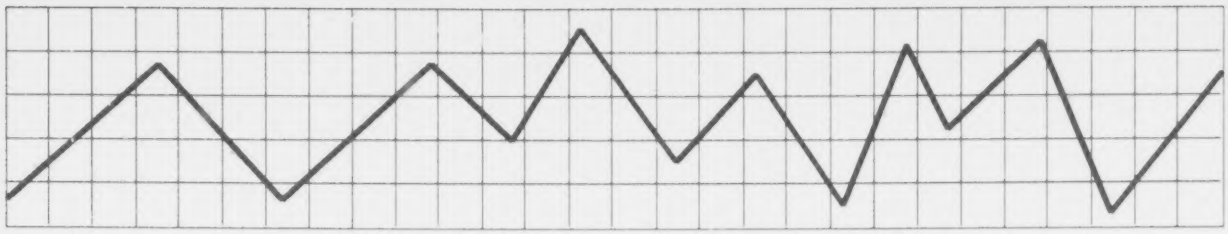
COMPETITIVE TAX DISADVANTAGES FACED BY U.S. MULTINATIONALS

A TAX FOUNDATION SPECIAL REPORT



Competitive Tax Disadvantages Faced by U.S. Multinationals

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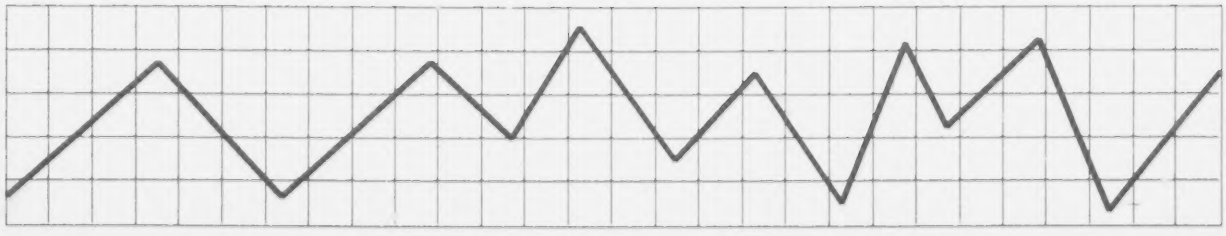

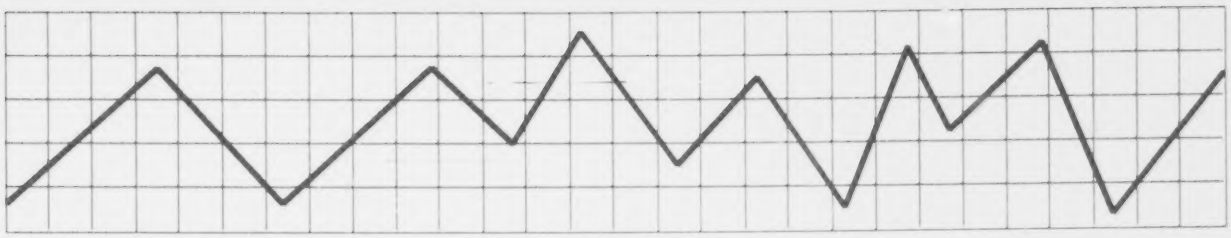

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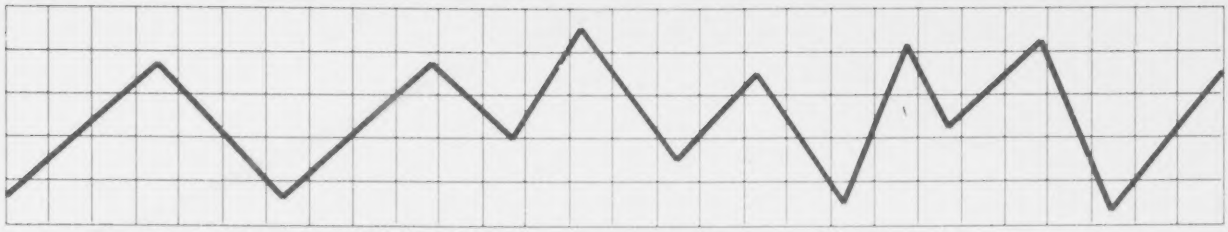
Abstract

This study evaluates some of the various tax factors that might affect the United States' ability to compete effectively with other industrialized nations. Unted States and foreign taxing authorities differ primarily with respect to the way foreign source income is taxed and the way tax incentives are granted. Many of the U.S. tax provisions affecting foreign source income of U.S. multinationals owe their genesis to the Revenue Act of 1962. But such provisions may have outlived their usefulness and may now be counterproductive in the economic environment of the 1990s. The areas of tax differences include the following:

1) tax sparing;
2) loans between a parent and its foreign affiliates;
3) unrepatriated foreign earnings;
4) federal tax burden on corporate earnings;
5) research and experimentation (R&E) tax incentives;
6) relative stability of revenue laws, and;
7) rebates of excise taxes on exports.

The study illustrates that U.S. tax laws may put U.S.-owned foreign affiliates at a cash-flow disadvantage when compared to other industrialized nations such as Japan and West Germany. Even though such cash-flow differences will tend to even out over the long-run, real differences over the short-run may act as an economic impediment to U.S. competitiveness internationally. To remedy counterproductive tax provisions, U.S. policymakers should:

1) recognize tax sparing under applicable tax treaties;
2) repeal dividend characterizations on loans to U.S. parents from U.S.-owned foreign affiliates;
3) offer additional federal tax incentives to lower the after-tax cost of research and experimentation; and
4) refrain from raising the effective corporate tax burden above that of our trading partners.



Competitive Tax Disadvantages Faced by U.S. Multinationals

Frequently, questions are raised about the specific tax and non-tax economic circumstances that may put the United States at a competitive disadvantage with its foreign trading partners. While much attention has been focused on non-tax trading practices, little consideration has been given to tax factors that could in fact have just as great an effect on U.S. competitiveness abroad. The purpose of this report is to evaluate some of the various tax factors, many of which originated in the early 1960s, that might affect U.S. ability to compete effectively with other industrialized nations. Suggestions also are offered for removing possible federal tax impediments on the international competitiveness of U.S. multinationals.

Profits earned by U.S.-owned affiliates in foreign jurisdictions are normally classified as foreign source income.[1] Such income is taxed in the U.S. when distributed as dividends, when included as Subpart F income, or when other income inclusion tax provisions apply.[2] Like Japan and West Germany, the U.S. generally does not tax the foreign source income of its affiliates until such earnings are repatriated. However, the U.S. imposes forced income reporting before repatriation on certain types of income earned by statutorily defined entities.[3] While Japan and West Germany also have forced income reporting, their provisions are less stringent than those in the U.S. By contrast, many foreign countries employ a tax system wherein foreign source income is generally not taxed until it is repatriated.[4]

Many of the U.S. tax provisions affecting foreign source income of U.S. multinationals owe their origin to the Revenue Act of 1962.[5] But economic conditions have changed drastically since then. A number of current provisions originating in the Revenue Act of 1962 sought to slow down the movement of capital from the United States to foreign locations.[6] Conventional wisdom before 1962 held that U.S. tax treatment of foreign source income resulted in "building up the economy of West Germany rather than the economy of West Virginia."[7]

The creation of economic opportunities in Eastern Europe and the planned integration of Europe ("Europe 1992") now require a greater foreign presence by U.S. multinationals. In the global economic environment of the 1990s, the application of tax provisions written to curb economic behavior of the early 1960s produces economic impediments to the competitiveness of U.S. multinationals abroad. U.S. exporters rely on foreign subsidiaries to a greater extent than their foreign counterparts. Approximately 72 percent of U.S. exports are handled through U.S.-owned foreign affiliates; this is significantly higher than the corresponding figure for our major trading partners.[8]

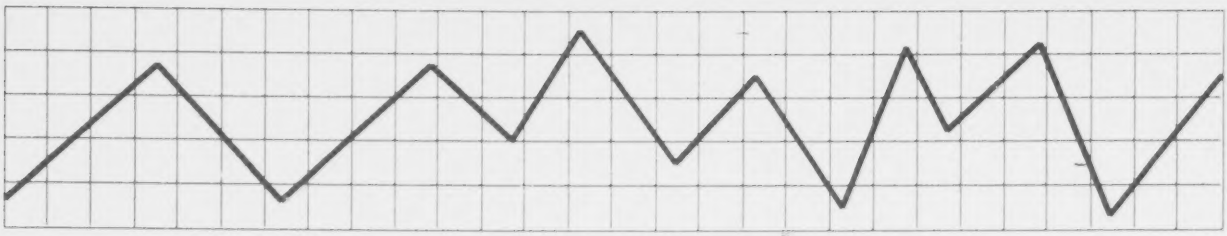
Tax Differences

When comparing the United States with its major trading partners, the areas of tax differences include:[9]

1. treatment of foreign tax spared;
2. treatment of loans between a domestic parent and its foreign subsidiary;
3. treatment of unrepatriated profits;
4. federal income tax burden on corporate earnings;
5. level of federal tax incentives for R&E;
6. relative stability and complexity of revenue laws; and
7. rebates of excise taxes on exports.

Tax Sparing

Tax sparing normally is initiated by foreign countries to attract inbound investments in specific geographic locations or industries. Typically, countries that are in need of capital investments grant businesses a tax holiday for a predetermined number of years. While most recipient foreign countries allow their multinationals to treat such taxes as actually paid for purposes of the deemed paid foreign tax credit, the U.S. does not.[10] Accordingly, U.S. multinationals pay the U.S. Treasury the tax they would have paid the foreign country had there been no tax sparing. The following example demonstrates the



tax sparing effect on U.S. multinationals not in limitation under Internal Revenue Code (IRC) Section 904 versus a West German and a Japanese multinational.[11]

Example 1. Assume that Corporations A, B, and C, subsidiaries of a German, a U.S., and a Japanese multinational respectively, earned $1 million each of net profits in Singapore. Also assume that Singapore has an effective tax rate of 32 percent, but because of an incentive for businesses to locate there, Corporations A, B, and C currently pay no corporate income tax. Further assume that all three subsidiaries pay out 50 percent of their earnings in dividends to their respective parent corporations.

As illustrated in Table 1, the West German and Japanese multinationals, because of a tax sparing treaty between their home countries and Singapore, retain $410,000 and $435,000 respectively of the dividend, takes away even with the 50 percent statutory West German tax rate and 45 percent Japanese tax rate (versus 34 percent in the U.S.) on foreign dividends. The U.S. firm keeps only $330,000 of the distribution because the U.S. does not recognize tax sparing. A major difference in after-tax proceeds results because both West Germany and Japan allow their multinationals to keep the tax savings granted by Singapore by permitting them a deemed paid foreign tax credit as if

Table 1
Tax Sparing

	West Germany - A	U.S. - B	Japan - C
Net Profits Before Tax in Singapore	$1,000,000	$1,000,000	$1,000,000
Tax by Singapore (32 percent)[a]	(320,000)	(320,000)	(320,000)
Tax Holiday by Singapore	320,000	320,000	320,000
Remitted to Parent as Dividend (50%)	500,000	500,000	500,000
Tax in Parent Country on Remittance (50/34/45)	(250,000)[b]	(170,000)[c]	(225,000)[d]
After Tax Remittance in Parent Country	250,000	330,000	275,000
Foreign Tax Credit Tax Sparing Allowance in Parent Country	160,000[e]	0[g]	160,000[h]
After Tax Dividend to Parent	**$410,000**	**$330,000**	**$435,000**

[a] Based on an assumed 32 percent statutory tax rate in Singapore which does not consider local taxes and special business incentives.

[b] $500,000 * 50 percent West German federal statutory tax rate (foreign dividends are assumed to be taxed at the 50 percent rate rather than the combined rate of 57.5 percent). The actual rate of taxation may vary from the rate used here.

[c] $500,000 * 34 percent U.S. statutory tax rate (State income taxes are not included).

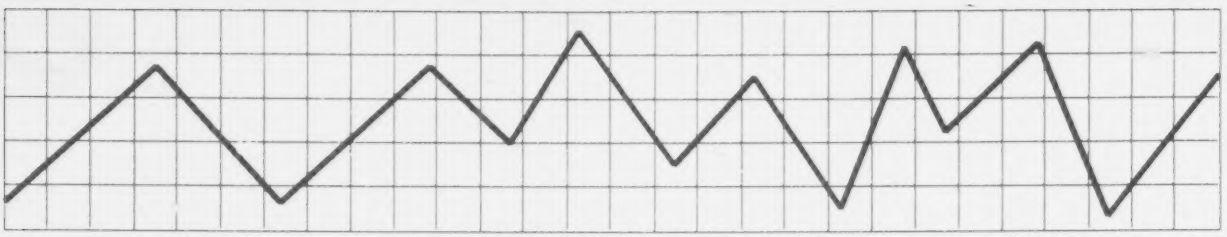
[d] $500,000 * 45 percent Japanese statutory tax rate (While the combined federal and state statutory rate is approximately 57-58 percent, foreign dividends are assumed to be taxed at approximately the 45 percent rate.

[e] The foreign tax credit is based on the lower of the U.S. or foreign tax.

[f] (32 percent * 1,000,000 * 50 percent deemed paid which assumes no other taxes are paid to produce a blended rate).

[g] The U.S. does not recognize tax sparing so the deemed paid foreign tax credit is denied unless the company is in limitation under IRC Section 904. Firms that are in limitation would be able to credit a higher amount of deemed paid foreign taxes under the limitation formula.

[h] (32 percent * 1,000,000 * 50 percent deemed paid which assumes no other taxes are paid to produce a blended rate).



they had paid taxes in Singapore. The U.S. Treasury, on the contrary, takes away this benefit by denying the foreign tax credit.

Of the six major industrial nations examined in Appendix 1, the U.S. is the only country that does not recognize tax sparing. The unavailability of tax sparing takes on significance mainly for companies that are not in an excess foreign tax credit situation and for companies that normally utilize unused deemed paid foreign taxes before expiration. Should the U.S. statutory tax rate increase relative to other countries, the tax sparing effect would also take on added significance. Based on the hypothetical figures in Table 1, a West German multinational is afforded 24 percent[($410,000-$330,000)/$330,000] more in cash-flows than a U.S. company, assuming a 50 percent distribution. Based on these assumptions, the Japanese multinational is afforded a 32 percent [($435,000 - $330,000)/$330,000] advantage over the U.S. multinational.

To address this counterproductive situation, U.S. policymakers should recognize partial or full tax sparing under applicable tax treaties by allowing a foreign tax credit on foreign taxes spared. The need for tax sparing is especially critical for companies that can fully credit foreign income taxes paid.

Loans From Foreign Affiliates

Loans between a U.S.-owned foreign affiliate and its U.S. parent are characterized as a taxable dividend assuming the foreign affiliate has sufficient earnings and profits (undistributed earnings). However, the U.S. parent is allowed to credit deemed paid foreign taxes on the assumed dividend. The amount of the loan characterized as a dividend is classified as previously taxed income. As such, when income is subsequently distributed, distributions will go tax-free to avoid double taxation.[12] However, companies with uncredited foreign income taxes may incur U.S. tax liability in the current year on loans characterized as a dividend without the ability to fully credit associated foreign taxes.

Dividend characterizations for loans have little significance unless the company cannot fully credit the associated foreign taxes in the current period. Companies that can fully use creditable foreign income taxes are able to offset additional U.S. tax liability resulting from loan recharacterizations by the associated deemed paid foreign income taxes.

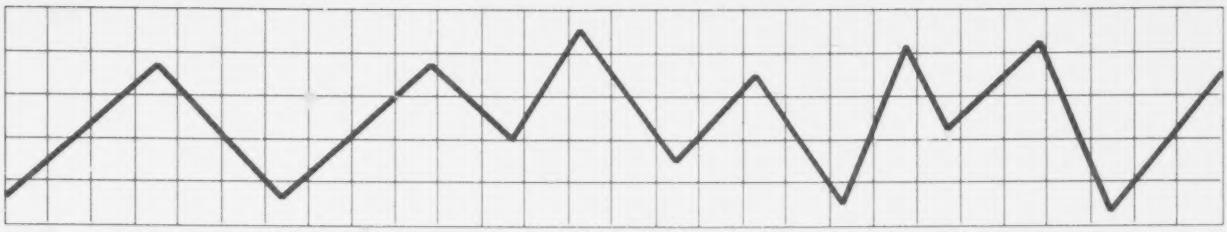
Appendix 1 shows that of the six countries examined, only the U.S. characterizes loans from foreign affiliates as a dividend. In effect, U.S. multinationals report taxable foreign source income on such loans as if the loan were made in lieu of a dividend. Foreign multinationals, on the other hand, are able to make similar loans without presumption of tax avoidance.

Dividend characterization on coordination center loans are likely to produce burdensome tax consequences. Coordination centers are usually granted full or partial tax respite on earnings attributable to certain business activities and, as a result, distributions from such entities attract little or no deemed paid foreign tax credit.[13] Earnings arising from coordination centers may be classified as separate limitation income, however. Therefore, such income would involve a separate foreign tax credit limitation basket, and thus, averaging with income from unrelated income baskets would be precluded.[14]

The following scenario illustrates the possible cash-flow differences between West Germany, Japan, and the U.S. for loans from a Belgian coordination center with a 2.15 percent effective tax rate to their respective parent corporations.

Example 2. Assume that West German, Japanese, and U.S. multinationals have coordination centers in Brussels, Belgium. Further assume that their parents need funds for expansion in their home countries and that each parent corporation borrows $1 million from their Belgian coordination centers at a 10 percent interest rate.

Table 2 shows the results for the West German, the U.S., and the Japanese parent corporations. All three parent corporations are allowed an annual tax deduction for the interest payments of $100,000 (10 percent * $1 million) to their respective parent corporations. The result would be annual tax saving of $58,000 (10 percent * $1 million * 58 percent) for the Japanese parent, $39,300 (10 percent * $1 million * 39.3 percent) for the U.S. parent, and $57,500 (10 percent * $1 million * 57.5 percent) for the West German parent. All three Belgian affiliates are assumed to pay $2,150 (10 percent * $1 million * 2.15 percent) in taxes on the inter-



est income received from the parent corporations. The Japanese and the West German parent corporations keep the $1 million loan, but the U.S. parent keeps only $681,500 [($1 million – (34 percent * $1 million) + (2.15 percent deemed paid credit * $1 million * 10 percent)] of the loan.

The major portion of the cash-flow difference occurs because the U.S. tax of $340,000 (34 percent U.S. statutory rate * $1 million dividend) attracts a deemed paid foreign tax credit of only $2,150 (2.15 percent * $1 million * 10 percent). Of course, companies that are in limitation under IRC Section 904 would be able to increase the amount of creditable foreign income taxes. Table 2 shows that due to the $1 million loan characterization as a dividend by the U.S., West German multinationals enjoy a $356,050 net benefit and Japanese multinationals enjoy a $356,550 net benefit over the U.S. Of course, when actual distributions takes place, both the West German and the Japanese parents will have to pay their taxing authorities the tax due. When dividend distributions or other income inclusion provisions apply, both parent corporations (West German and Japanese) will be able to credit foreign income taxes paid by their respective coordination centers.

The analysis (Table 2) shows that for a similar amount of loan, the U.S. multinational could be put at a cash-flow disadvantage when compared to their foreign counterparts.[15] To correct this possible competitive impediment, the U.S. Treasury should forego the tax revenues produced by taxing such loans. Doing so would grant U.S. multinationals greater levels of freedom in utilizing corporate resources on a global basis without a tax incidence. Failure to do so may handcuff corporate management in allocating scarce corporate resources among countries as it sees fit.

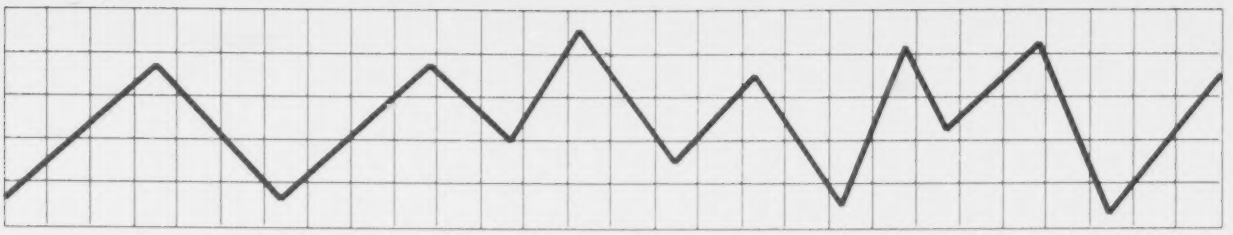
Unrepatriated Earnings

Subpart F is a method of taxing certain types of earnings of a U.S. multinational's foreign subsidiary

Table 2
Loans from Foreign Coordination Center

	West Germany	U.S.	Japan
Loan from Coordination Center @ 10 Percent Interest	$1,000,000	$1,000,000	$1,000,000
Tax Benefit from Interest Deduction in Parent Country	57,500[a]	$39,300[b]	58,000[c]
Tax on Loan Deemed to Be Dividend	0	(340,000)[d]	0
Foreign Tax Credit on Dividend	0	2,150[e]	0
Tax on Interest Income in Coordination Center	(2,150)	(2,150)	(2,150)
Tax (Cost)/Benefit on Loan from Coordination Center	$55,350	0	$55,850
Net Benefit[g]	**$356,050**	**0**	**$356,550**

[a] (10 percent interest * $1,000,000 * 57.5 percent German statutory tax rate).
[b] (10 percent interest * $1,000,000 * 39.3 percent combined federal and state U.S. corporate statutory income tax rate).
[c] (10 percent interest * $1,000,000 * 58 percent Japanese statutory tax rate).
[d] (34 percent U.S. statutory rate * $1,000,000 dividend assuming sufficient earnings and profits).
[e] (2.15 percent effective Belgian tax rate on coordination centers * 10% * $1,000,000). No adjustments are made for the after-tax cost of this tax in the respective home countries. Because the $2,150 in Belgian tax affects all three companies it does not change the bottom line numbers.
[f] (10 percent interest * $1,000,000 * 2.15 percent Belgian statutory rate on coordination centers' income).
[g] The net benefit is derived by adding the tax detriment in the U.S. column to the tax benefits in each country's column.



before such earnings are repatriated as dividends. The Subpart F provisions were enacted primarily to discourage the investment of assets or unrepatriated earnings of U.S.-controlled foreign corporations in passive type foreign activities. But in its current form, the Subpart F provisions may be counterproductive. The following example illustrates the breadth of the Subpart F rules:

Example 3. Consider U.S. multinational, A, with two foreign subsidiaries, B and C. Corporation A routinely sells to B and C in arm's length transactions products which B and C resell in their respective countries of incorporation. During a period of peak demand, an order for a sale develops in Country X which Corporation A cannot meet out of its U.S. inventories. Corporation A directs Corporation B to satisfy the demand in Country X. Because B is selling outside its country of incorporation, whatever profits it makes are currently taxable to its parent in the U.S. under the Subpart F rules. Most of corporation A's foreign competitors enjoy a deferral of tax under similar circumstances (see Appendix 1).

As with the preceding *foreign base company sales income* Subpart F example, a Japanese, West German, or Dutch multinational can transfer capital or intangible assets, such as patents, to foreign countries and in some instances escape tax on the earnings from the assets until such income is repatriated. Under U.S. tax laws income from such transfers of assets is more often taxed under Subpart F. In addition, outbound transfers of such assets from the U.S. can be (and usually are) subject to a tax under IRC Section 367. The IRC Section 367 toll charge on technology transfers may discourage joint ventures requiring U.S. technology.

Appendix 1 shows that of the countries examined, all have limited Subpart F provisions as compared to comprehensive provisions in the United States. In particular, the trading partners examined herein do not apply the *foreign base company sales income* provisions in a manner similar to the U.S. Therefore, foreign multinationals are economically advantaged in that they can indefinitely defer paying tax liabilities from such transactions to finance their foreign expansions while U.S. multinationals must depend on the after-tax proceeds from similar transactions.

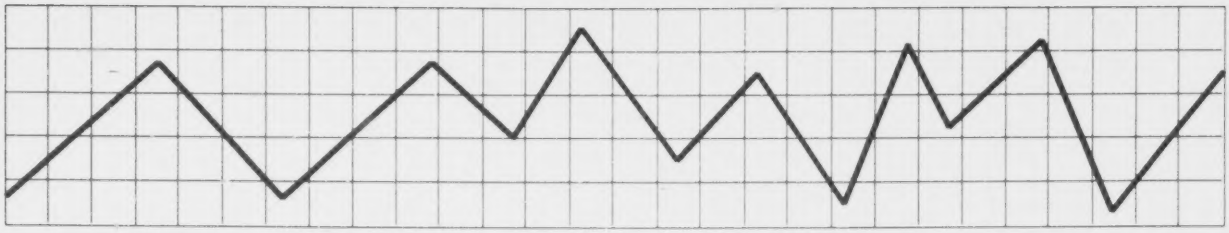
When Subpart F provisions are applied by the U.S. in a more punitive fashion than other major industrialized countries, competitive impediments are imposed on U.S. firms. Because of the current structure of the Subpart F provisions, the foreign source income of U.S. multinationals seems to have the highest likelihood of being taxed before repatriation. The Passive Foreign Investment Company (PFIC) provisions together with the Subpart F provisions appear to sacrifice future profitability and expansion in favor of current revenues for the U.S. Treasury. Indeed, the use of undistributed earnings to expand in current and existing foreign markets could produce higher levels of revenues to the U.S. Treasury in future years.

Corporate Tax Burden

Appendix 2 shows the total statutory tax rates on corporate earnings for various countries. As with Appendix 1, the focus is on the six nations compared in this paper. As reflected therein, the U.K. has a federal statutory tax rate of 35 percent on corporate entities; Canada has a rate of 39 percent; the Netherlands has a 42 percent rate; West Germany's rate is 50 percent; and Japan has a rate of 37.5 percent.[16] As shown, the U.S. has the lowest statutory federal income tax rate. However, the 39 percent Canadian statutory rate is rebated to 29 percent for provincial taxes.

The combined statutory rates for both Japan and West Germany are approximately 57-58 percent, while in the U.S. it is approximately 39.3 percent. The implication is that it is more expensive to do business tax-wise in West Germany and Japan than it is in the United States. U.S. businesses in countries with statutory tax rates in excess of the U.S. statutory tax rate may not be able to fully credit, immediately, all foreign income taxes deemed paid.

Because the U.S. tax rate of 34 percent is lower than some of its major trading partners like West Germany and Japan, the U.S. appears to serve as a tax haven comparatively and could motivate its



multinationals to locate the bulk of their business in the U.S. rather than in foreign locations. In addition, West German and Japanese businesses may find it economically attractive when compared to their home countries for manufacturing goods destined for U.S. consumption. But the statutory rate may be misleading because it does not consider the definition of the tax base.

By contrast, the effective rate may be a more representative barometer than the statutory rate because it is computed using both the statutory rate and the tax base. Therefore, differences in the definition of the tax base will be reflected in the effective rate. For instance, the Tax Reform Act of 1986 lowered the statutory corporate tax rate but it may have widened the tax base relative to other nations. Typical methods of widening the tax base include: 1) denying part or all of certain business deductions, and 2) defining gross income more broadly.

Assuming the statutory corporate income tax burden is a major factor in locating business facilities, U.S. policymakers should refrain from increasing above current levels the statutory federal tax rate or the effective tax burden on corporate profits. The present statutory corporate income tax rate advantage could motivate U.S. multinationals to locate manufacturing facilities in the U.S. rather than in foreign locations.

Indeed, if the statutory tax rate on corporate profits earned in the U.S. is raised above the rates of other countries, additional revenues may be garnered from domestic source income. However, a rate increase would allow foreign affiliates of U.S. multinationals to credit higher amounts of foreign taxes deemed paid on the same amount of foreign source income. Moreover, if the trading partners respond in kind, added competitive impediments are imposed on U.S. firms abroad.

Research and Experimentation Tax Incentives

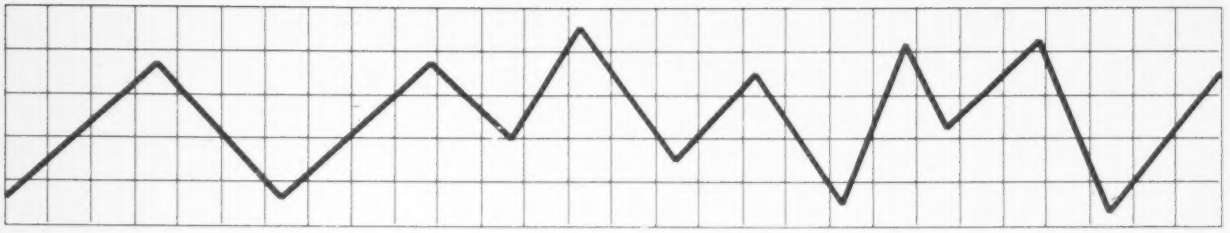
Credit Formula. Appendix 1 shows that all the included nations except West Germany and the Netherlands allow a credit against federal taxes for a percentage of spending on research and experimentation (R&E). As a result, the after-tax cost of R&E may differ among countries based on the level of tax incentives offered by each country. The way the formula limits the R&E credit impacts the creditable amount of R&E expenditure and, as such, the after-tax cost of R&E. In turn, the after-tax cost of R&E may affect the level of R&E funding.

Japan's R&E formula grants a credit of 20 percent of R&E expenses in excess of the lesser of the highest dollar amount in any prior year or 10 percent of taxable income. The U.S. grants an R&E credit through a basic research credit and an incremental credit formula.[17] The basic research credit is 20 percent of the excess of basic research expenses over a base amount.[18] But basic research typically must be paid in cash to universities or similar organizations. The U.S. incremental credit also is 20 percent of the excess of incremental R&E expenses over a statutorily defined base figure. The base amount for the incremental credit is determined as follows:[19]

$$\frac{\text{R\&E expenses for taxable years 1984-1988}}{\text{Gross receipts for taxable years 1984-1988}} * \text{Average gross receipts for prior four years}$$

Under IRC Section 41, the ratio of R&E expenses to gross receipts over the 1984-1988 period cannot exceed 16 percent.[20] In addition, the R&E eligible for the credit cannot be greater than twice the base figure. As such, unlike other industrialized nations, the U.S. R&E credit is based on the historical relationship between R&E and gross receipts. Prior to January 1, 1990, the R&E credit also was available through an incremental formula and a basic research formula. The incremental approach allowed a credit for expenditures in excess of the average of the prior three years' R&E spending. The basic research formula was not changed by the Revenue Act of 1989, but as indicated above, the incremental credit provisions were substantially revised.

While well intended, the incremental R&E credit may have little or no effect in stimulating technological innovation in the United States. The revised incremental credit provisions may have provided more generous benefits for some companies, but it appears to do little in to encourage R&E at levels comparable to other major industrial nations such as Canada, France, and Japan (see Appendix 1 and Figure 1).



Based on a sample of 92 firms, the average effective rate of the incremental R&E credit appears to fall well below 6.6 percent for most companies.[21] Indeed, the projected average effective rate of credit for 1990 is 2.6 percent. Table 3 discloses the effective rates of R&E credit for a number of firms in various industries.

Many firms already experiencing a declining trend in discretionary funds from which to fund R&E may face partial or full denial of the incremental credit. Significantly, the fixed base percentage formula appears to penalize firms or entire industries, over the short-run, facing financial downturns. Of the ninety-two firms examined, nineteen had a declining trend in sales along with a declining trend in R&E. Twelve of these firms were denied the credit under both the fixed base percentage formula and the moving average formula. Indeed, the fixed base percentage formula is more punitive than the moving formula when R&E declines at a faster rate than sales. In such circumstances, however, the credit may be most needed because of limited financial resources to finance costly projects such as R&E.[22]

The availability of the credit remains uncertain because of its currently temporary status under the U.S. Tax Code. The uncertainty regarding the availability and the magnitude of the credit makes any planning and long-term investment difficult.

In addition, IRC Section 861 and the associated Treasury Regulations require the allocation of a portion of U.S. R&E outlays to foreign source income. The result is that as the ratio of foreign to U.S. source income increases, the amount of U.S. R&E that must be allocated against foreign source income increases. For each dollar of U.S. R&E converted into foreign deductions; the available deemed paid foreign tax credit is reduced in the current period and in some instances may expire without being used.

How the U.S. Compares With Trading Partners. Figure 1 shows that while the Japanese have significantly increased their non-defense related R&E since 1978, the U.S. has not increased its non-defense R&E since 1972 except for a slight increase between 1979 and 1981. Figure 1 also shows that West Germany has increased non-defense R&E from a low of 2 percent of gross national product (GNP) in 1977 to a high of 2.6 percent in 1985. Table 4 shows that the U.S. share of the global sales of technology-intensive products has been declining with respect to the Japanese share of such exports [National Science Foundation, 1988].[23] Closer examination of Table 4 shows that while the U.K. share declined from 12 to 9 percent, the remaining countries (except for the U.S. and Japan) experienced little change over the 1965-1986 period.

The conclusion is that U.S. R&E spending and its proportion of global sales of technology-intensive products have both been decreasing relative to other industrialized nations, especially Japan [National Science Foundation, 1988; Mills, 1988; Beath and Katsuolacos, 1989]. No inference is made here regarding cause and effect between the after-tax cost of R&E and exports. Nonetheless, these figures suggest that greater amounts of corporate resources should be allocated to R&E.

One way for U.S. policymakers to influence this trend is to lower the after-tax cost of R&E spending for U.S. businesses. Ways of lowering the after-tax cost of R&E include: 1) replacing the incremental R&E credit formula with a system based on a simple percentage of the current year's qualified R&E; 2) allowing a tax deduction for R&E spending whether or not an R&E credit was allowed; and 3) repealing the requirement to allocate a portion of U.S. R&E spending to foreign source income.

Relative Stability of Revenue Laws

When compared to the tax law in other industrialized nations such as Japan, West Germany, and the United Kingdom, U.S. tax law severely lacks stability. Annual material changes in the U.S. tax laws have been occuring since the early 1960s. As a result, long-range planning of U.S. multinationals relative to their foreign counterparts can be costly and suboptimal. Table 5 shows a list of changes in the corporate federal tax provisions affecting U.S. parent corporations of foreign affiliates in recent years. These changes required significant corporate resources in training and time spent to fully comply on a timely basis. With less frequent changes a portion of corporate resources spent on tax compliance can be reallocated to more productive uses.

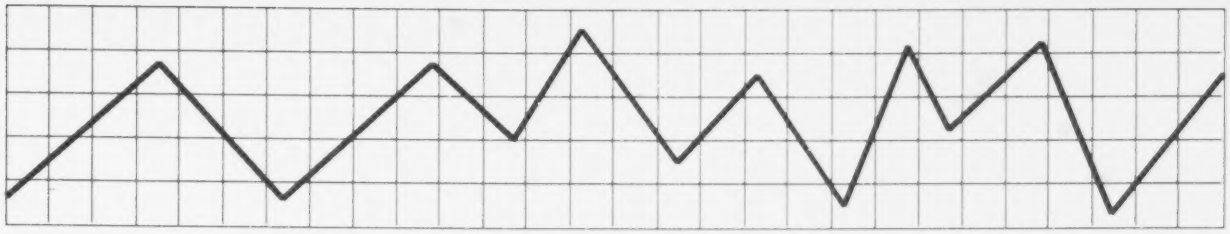


Table 3*
Projected Effective Rates of R&E Credit for 1990

	Moving Average Formula	Fixed Base Percentage Formula
Aerospace		
Boeing	4.15	4.76
General Dynamics	1.50	3.91
McDonnell Douglas	0.81	1.69
Automotive		
Chrysler	1.88	2.63
Ford Motors	1.96	2.40
General Motors	1.64	2.59
Cummin Engines	0.28	2.34
Dana	0.69	0.86
Chemical		
American Cyanamid	2.15	3.25
Dow Chemical	2.03	2.47
DuPont	1.21	1.93
Monsanto	0.88	1.65
Drugs		
American Home Products	2.56	3.38
Merck	2.56	3.34
Pfizer	1.74	3.30
Rorer Group	3.06	4.92
Schering-Plough	2.28	3.35
Electrical		
Ametek	2.24	2.50
Baldor Electric	2.68	3.54
Emerson Electric	1.30	2.26
Square D	0.85	1.11
Electronic		
General Instrument	3.02	0.23
Harris	4.46	4.79
Motorola	3.19	3.85
Raytheon	1.78	1.25
Varian Assoc.	1.01	0.43
Food		
Borden	1.70	0.94
General Mills	2.21	0.13
Kellogg	2.10	1.65
Quaker Oats	1.91	3.29
Ralston Purina	2.22	3.99
Fuel		
Amoco	1.34	4.44
Atlantic Richfield	0.00	0.01
Chevron	0.10	0.62
Exxon	0.97	0.00
Kerr-McGee	2.55	4.67
Phillips Petroleum	0.99	2.36
Unocal	0.91	5.17
Computers		
Digital Equipment	2.19	3.27
Hewlett-Packard	3.36	3.95
IBM	1.62	2.16
NCR	1.27	1.77
Computer Peripherals		
Intergraph	2.42	3.76
National Computer Systems	0.96	0.00
Software		
Ashton-Tate	3.91	6.60
Computer Associates	6.17	6.09
Lotus	4.59	6.60
Instruments		
Foxboro	0.51	0.00
General Signal	1.81	3.07
Johnson Controls	3.72	4.33
Tektronix	0.33	1.48
Leisure Industries		
Bally Mfg.	1.62	0.99
Brunswick	0.15	0.66
Hasbro	1.16	2.71
Mattel	1.87	1.78
Tonka	2.97	5.27
Machinery		
Caterpillar	1.59	0.00
Dover	2.51	3.98
FMC	1.94	2.19
Machine Tools		
Briggs & Stratton	0.99	1.49
Cincinnati Milacron	0.26	0.00
Clark Equipment	0.82	0.00
Ingersoll-Rand	2.16	1.06
Timken	1.34	1.87
Semiconductors		
Analog Devices	0.77	2.55
Intel	3.00	3.27
Texas Instruments	0.74	1.57
Metals		
Brush-Wellman	0.00	0.71
Carpenter Technology	0.85	0.00
Reynolds	0.50	0.00
Telecommunications		
AT&T	1.03	2.90
Communications Satellite	2.23	0.16

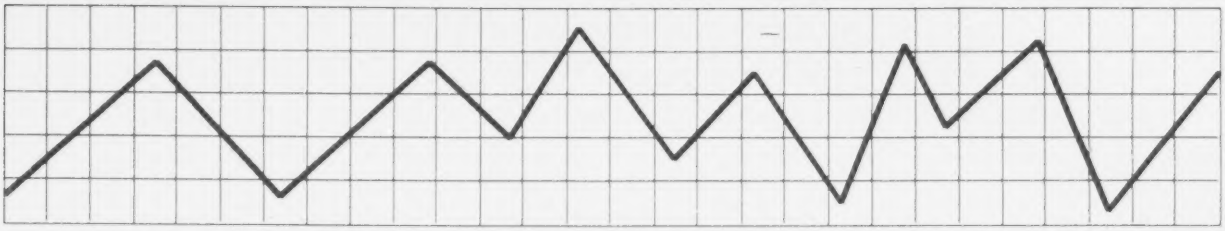


Table 3 (Cont'd)

	Moving Average Formula	Fixed Base Percentage Formula		Moving Average Formula	Fixed Base Percentage Formula
DSC Communications	3.76	3.45	MIA Com	2.98	3.61
GTE	1.71	1.13	Moog	0.63	1.75
			Sunstrand	2.00	4.85
Defense Contractors			Textron	0.21	0.63
EDO	1.81	4.01	Watkins-Johnson	1.20	1.45

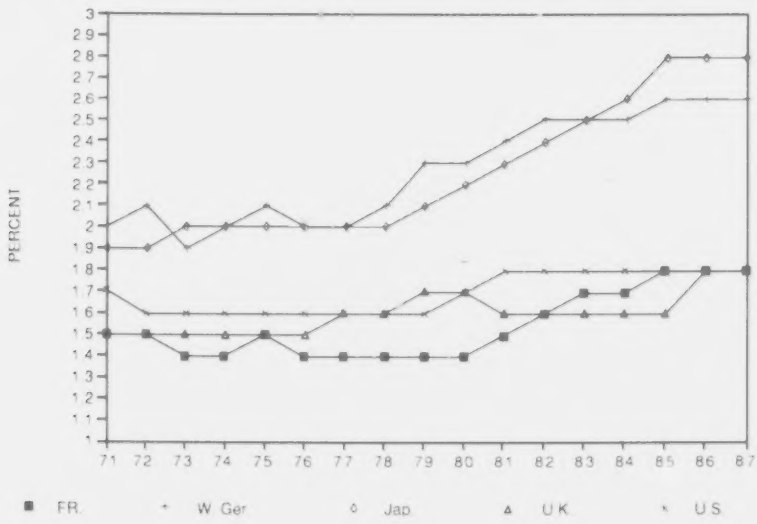
* The actual rates of credit may be different from the ones presented herein because of the use of world-wide gross receipts to calculate the credit rather U.S. gross receipts and because of the definition of R&E expenses.

Table 4
World Export Shares of Technology-Intensive Products: 1965-86
(percent)

Year	France	West Germany	Japan	United Kingdom	United States
1965	7.3	16.9	7.2	12.0	27.5
1966	7.4	16.9	8.3	12.3	27.1
1967	7.5	16.7	8.5	11.1	28.2
1968	6.8	16.2	9.5	10.3	29.1
1969	7.0	16.6	10.7	10.1	27.8
1970	7.1	16.8	10.9	9.8	27.0
1971	7.1	16.5	11.6	10.3	26.2
1972	7.3	17.0	12.7	10.0	23.7
1973	7.6	18.3	12.4	9.2	23.7
1974	7.5	18.1	12.0	8.8	24.4
1975	8.4	16.8	11.6	9.6	24.5
1976	8.4	17.3	13.7	8.6	23.5
1977	8.4	17.7	14.5	9.1	22.0
1978	8.5	17.9	15.2	9.8	21.3
1979	9.3	17.6	13.6	9.9	21.9
1980	8.5	16.3	14.3	10.9	22.9
1981	7.9	14.8	17.4	9.0	25.0
1982	8.3	15.5	16.2	9.4	24.7
1983	7.7	15.0	17.8	8.7	25.1
1984	7.7	14.5	20.2	8.5	25.2
1985	7.9	14.8	19.4	9.2	24.2
1986	7.9	16.0	19.8	9.0	20.9

Source: National Science Foundation. *International Science and Technology Data Update:1988.*(NSF 89307) Washington, D.C., 1988.

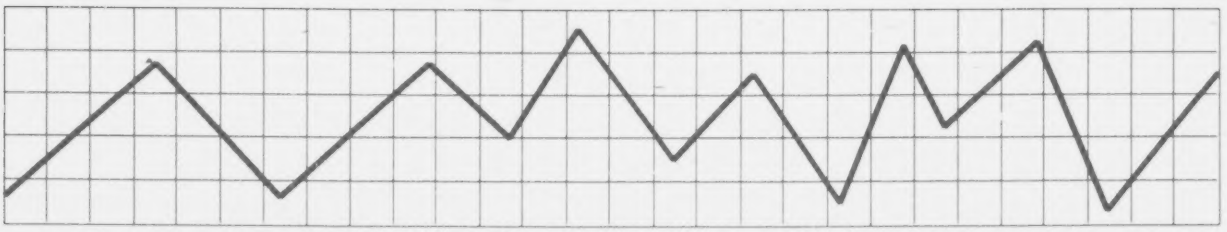
Figure 1
Estimated Non-Defense R&E Expenditures as a Percent of GNP, 1971-1987



Source: National Science Foundation. *International Science and Technology Data Update: 1988.* (NSF 89-307) (Washington, D.C., 1988.)

Table 5
Material Changes in the Internal Revenue Code/Regulations Regarding Foreign Investment and Planning Since the Tax Reform Act of 1986

1. Passive Foreign Investment Company	a. Relationship to Subpart F. b. Relationship to look-through rules.
2. Foreign Currency Gains and Losses	a. Branch accounting. b. Forward contracts.
3. Calculation of Foreign Tax Credit Limitation	a. Allocation of overheads including interest charges and R&E expense.
4. Earnings and Profits	a. There may be as many as four different methods of calculating E&P, all of them required by law for four different purposes.
5. Legislation Through Litigation	a. The resolution of the *Goodyear Tire* case informed taxpayers of the legal basis for calculating E&P of foreign affiliates (the use of foreign versus U.S. law was in question).
6. Frequency of IRC Changes	a. Revenue Acts of 1987, 1988, and 1989 revised the corporate provisions affecting domestic and foreign operations.
7. Intercompany Pricing	a. The Section 482 intercompany pricing rules explained by the "White Paper" leave many unanswered questions.



Some of the items enumerated in Table 5 have received both Congressional and U.S. Treasury attention with appropriate changes, and some of these items continue to create uncertainty. Corporate tax planning is made much more difficult by the legislative and administrative propensity toward annual fourth quarter "refinements" of the body of the tax laws affecting foreign and domestic transactions. In recent years, the passage of a retroactive tax bill late in the taxable period seems to be a typical method of operation. Even with the benefit of modern day high-speed computers, compliance with tax law changes may take a significant period of time and financial resources that may be needed for other projects.

Rebates of Excise Taxes on Exports

Rebates of excise taxes often are used indirectly by foreign governments as export incentives. Typically, excise taxes are levied on imports and goods manufactured and consumed domestically, but such taxes often are rebated or eliminated on goods destined for export.

Japan, for instance, levies a commodity tax on most consumer products produced in Japan. Motor vehicles normally are taxed at a rate between 5-30 percent depending on the size of the vehicle [Campbell and Yu, 1987; OECD, 1981; U.S. Government Printing Office, 1989]. If the product is destined for export, the tax is waived or is significantly reduced. West Germany levies a value added tax of approximately 14 percent, but the tax is waived on exported goods [U.S. Government Printing Office, 1989; Commerce Clearing House, 1990].

Conclusion

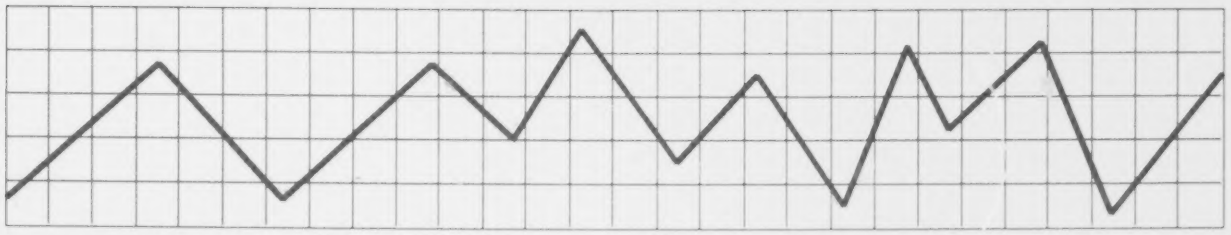
The competitiveness of U.S. corporations with foreign multinationals appears to be adversely affected by a number of tax and non-tax economic factors. Indeed, a number of tax provisions affecting foreign source income of U.S. multinationals owe their genesis to the Revenue Act of 1962. But such provisions may have outlived their usefulness in the economic environment of the 1990s.

The U.S. tax laws impose a tax burden on certain transactions that reduce the after-tax cash flow of U.S. multinationals relative to their foreign multinational counterparts, at least temporarily. As a result, foreign multinationals appear to have more cash resources to reinvest. In addition, instability in the U.S. tax laws when compared to those of other major industrialized competitors may hinder U.S. multinationals in the formulation of long-term investment strategies.

Because U.S. exporters rely more on foreign affiliates than do foreign exporters, the disproportionate tax burden on U.S.-owned foreign affiliates will likely affect American exports to a greater extent than foreign exports. As a result, the profitability and the level of strategic foreign presence of U.S.-owned foreign affiliates are critical in addressing America's trade problems.

U.S. policymakers can do their part to promote the competitiveness of U.S. multinationals by:

1) not forcing early reporting of unrepatriated foreign earnings;
2) recognizing tax sparing under applicable tax treaties;
3) offering additional federal tax and non-tax incentives to lower the after-tax cost of technological innovation; and
4) refraining from raising the effective corporate tax burden higher than the level of our trading partners.



Footnotes

[1] See IRC Sections 861-865 and 904(g).

[2] See IRC Sections 951-964. The Passive Foreign Investment Company (PFIC) provisions of IRC Sections 1293-1297 also could force early income reporting.

[3] The Subpart F provisions under IRC Sections 951-964 impose forced income reporting before repatriation. Other related provisions also could force early reporting. The statutorily defined entities include Controlled Foreign Corporations, Foreign Personal Holding Companies, and the Passive Foreign Investment Company provisions.

[4] While Switzerland and the Netherlands use the place of effective management as the criterion for determining the tax status of income (foreign or domestic source), France focuses on the performance of economic process as the determinant. Belgium, on the other hand, looks to the place of primary establishment, direction, or control.

[5] H.R. 1447; Public Law 87-834 (87th Cong. 2nd Session, March 16, 1962).

[6] While the flight of U.S. capital to foreign locations was a significant focus of the Act, the perceived abuse of tax-haven opportunities abroad by U.S. multinationals was the primary target of the 1962 changes. The Subpart F provisions are a good example of the legislative action.

[7] Public Law 87-834 (87th Cong. 2nd Session, March 16, 1962).

[8] "U.S. Multinational Companies: Operations in 1987," *Survey of Current Business*, 69(6), 27-39.

[9] Partly based on Haas, Raymond "U.S. Tax Policies Hurt U.S. Multinationals," *CPA Journal* (October, 1989) pp. 62-73. See Appendices 1 and 2 for a comparison of these and other relevant factors. The list of tax provisions considered here is not exhaustive. Other tax provisions such as the IRC Sections 861 and 864 allocations and the foreign tax credit baskets are also of significance.

[10] See Appendix 2 for a comparison of the countries with respect to tax sparing. Because the U.S. imposes an overall formula for each basket of income, income of a like basket that is subject to different tax rates is averaged to possibly increase the available deemed paid foreign tax credit.

[11] The examples to follow are based primarily on the statutory federal tax burden. As such, to the extent that state, inhabitant's, municipal, or local taxes vary significantly among countries, this could further exacerbate or narrow the differences shown in the examples. Local taxes are by and large ignored because of the potential to vary significantly within taxable jurisdictions.

[12] An IRC Section 902 deemed paid foreign tax credit is available to certain U.S. shareholders when foreign source income becomes subject to U.S. taxation.

[13] For instance, Belgium levies an approximate effective tax rate of 2.15 percent on income of coordination centers. As such, the U.S. parent of the coordination center is allowed a deemed paid foreign tax credit of no more than the 2.15 percent deemed paid credit. Income of a like basket is averaged among countries. As a result, income that is subject to a tax rate lower than the U.S. can be averaged with income subject to rates higher than the U.S.

[14] The application of the look-through rules could produce general limitation income. Under such a scenario, the coordination center income and the general limitation income could be blended to increase the foreign tax credits available.

[15] Once again, applicability of the look-through rules could increase the available foreign tax credit. The results also will not hold for firms in an excess foreign tax credit situation.

[16] The rates reflect the federal tax burden and, therefore, do not account for special credits, deductions for related taxes, or denials of specific deductions.

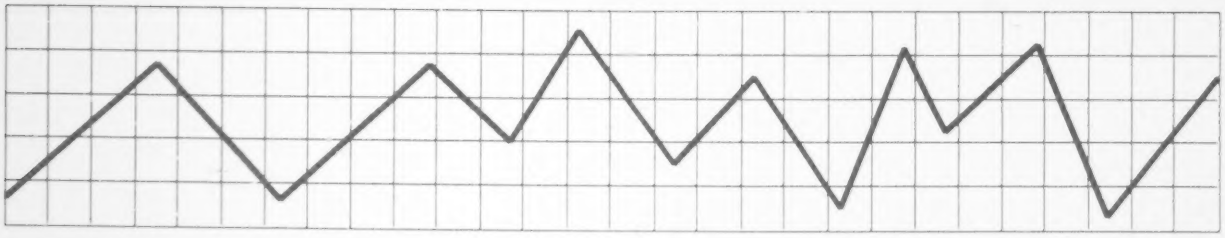
[17] A non-refundable R&D credit has been available for incremental research expenses paid or incurred after June 30, 1981 and before January 1, 1991. The credit was extended by the Revenue Reconciliation Act of 1989 (Pub. Law No. 101-239). The credit is extended so as not to apply to amounts paid or incurred after September 30, 1990.

[18] See IRC Section 41.

[19] See IRC Section 41(1990). In no case can the ratio of R&E expenses over the base period to gross receipts over the base period exceed 16 percent. Businesses that do not have the requisite number of years existence must use 3 percent in lieu of the ratio of R&E to gross receipts. Taxpayers can elect to reduce the R&E by the credit percentage if R&E expenses are to be deducted.

[20] For tax years beginning before October 1, 1990 and ending after September 30, 1990, a special rate applies which limits the expenses eligible for the credit. For a calendar year taxpayer, an amount determined by the ratio of the number of days from January 1, 1990 (273) to 365 days times the total R&E expenses for 1990 is eligible for the credit. For fiscal year taxpayers, the ratio is determined by the total number of days before October 1, 1990 divided by 365 days (Act Section 7110[a][2]).

[21] The data was taken from a number of sources including: 1) *COMPAC Disclosure*, 2) *Valueline Investment Survey*, and 3) *Moody's Industrial Manual*. The R&E figures are those reported for financial reporting purposes. In addition, the R&E credit is calculated based on worldwide sales and R&E figures. As such, the actual rates of the credit may be different from the ones



presented here. Because foreign sales may have been growing much faster than U.S. sales for many U.S.-owned firms, such a trend will tend to lower the R&E credit below the rates presented herein.

[22] This conclusion is based on additional analysis conducted by the authors. The analysis reveals that R&E intensity declines as sales decline in which case the fixed base percentage formula breaks down. Indeed, the effect becomes pronounced where R&E declines at a higher rate than sales.

[23] Technology intensity is assumed to be present where the cost of R&E exceeds 2.5 percent of value added.

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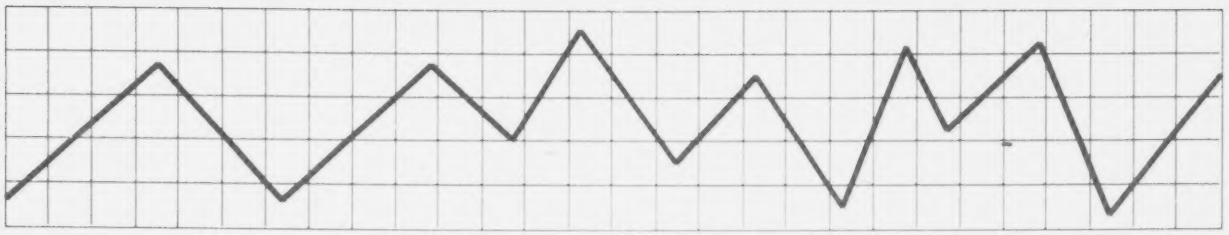


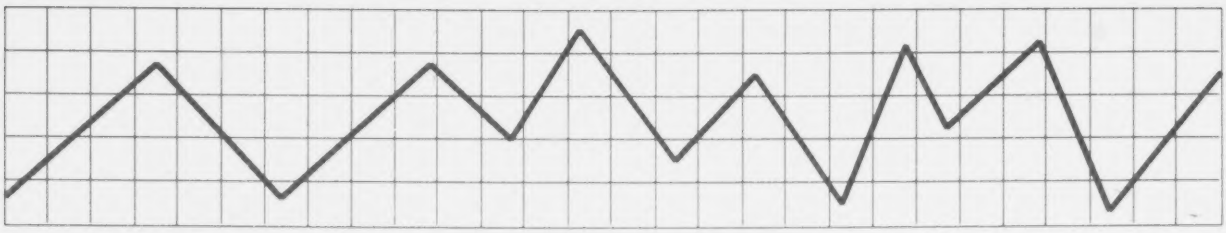
Appendix 1

Comparison of Foreign Tax and Other Economic Factors of Major Industrial Nations

	United States	United Kingdom	Japan	Germany	Netherlands	Canada
Recognition of Tax Sparing	No	Yes	Yes	Yes	Yes	Yes
Taxation of Unrepatriated Earnings	C	L	L	L	No	L
Taxation of Subsidiary's Loan to Parent Corporation	Yes	No	No	No	No	No
Imposition of Foreign Base Company Sales Income Provisions	Yes	No	No	No	No	No
Rebate of Excise Taxes on Exports	L	NI	C	NI	NI	NI
Research and Experimentation	20%T	25%G	20%T	None	None	20-35%[a]
Foreign Sales Corporation or Equivalent	Yes	NI	No	No	No	No

Legend:

L = Limited
C = Comprehensive
G = Grant
T = Tax Credit
NI = No Information available.
[a]The 20 percent rate applies to large companies and the 35 percent rate applies to small companies.



Appendix 2

Relative Statutory Tax Rates

	United States	United Kingdom	Japan	Germany	Netherlands	Canada
Maximum Tax Rate on Undistributed Earnings	34%	35%	37.5%	50%[a]	42%	39%[b]
Average State Local & Municipal Tax Rate	5.3%	N/A	19.5%	7.5%	None	8.5%
Average Statutory Total Rate	39.3%	35%	58%	57.5%	42%	47.5%
Maximum Value Added Tax Rate	None	15%	None	14%	20%[c]	7.0%[d]

* Appendix 1 consists primarily of the statutory tax rates and does not take into account the interaction of federal and state and local taxes. Withholding taxes on dividends vary widely based on payor and payee. As such, the rates above ignore withholding.

[a] This tax rate applies to distributions to shareholders. Shareholders get a tax credit for dividends.

[b] The nominal tax rate is 45.5 percent but the rate is reduced to 39 percent on income arising from Canadian manufacturing and processing. In both cases, a 10 percent abatement is allowed for provincial taxes.

[c] The rates vary from 6-20 percent. The 6 percent rate is levied on basic necessities.

[d] Currently, a federal sales tax of 12 percent is levied on a manufacturer's selling price of Canadian manufactured goods and on the duty paid on imports. A 7 percent GST will apply January 1, 1991.

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